



Economic Update

Committee on the Budget • Majority Caucus
U.S. House of Representatives
Jim Nussle, *Chairman*

309 Cannon House Office Building
Washington, DC 20515 • (202) 226-7270
James T. Bates, *Chief of Staff* • www.budget.house.gov

Volume 5, Number 5

14 June 2006

Moderate Real Growth Forecast for Rest of 2006

Overview

The Nation's economic growth rate was revised upward by one-half percent at the beginning of May – from what was already the fastest growth in 2½ years and more than double the rate of the previous quarter. Most analysts nevertheless project that, after 3 years of above-trend expansion, slower consumer spending will return overall economic growth to more moderate rates – though still healthy ones – over the remainder of the year. The projection is contingent on continuing productivity growth and reducing inflation.

Job growth and other employment indicators, including average wages and hours worked, also appear to be reaching levels that, if sustained, will keep unemployment low and minimize slack in labor markets.

Inflation has become the greater concern. Federal Reserve officials are uneasy about signs that higher energy prices are feeding through to the general price level. Markets consider it highly probable that the Federal Open Market Committee [FOMC] will announce another rate increase following its 29 June meeting.

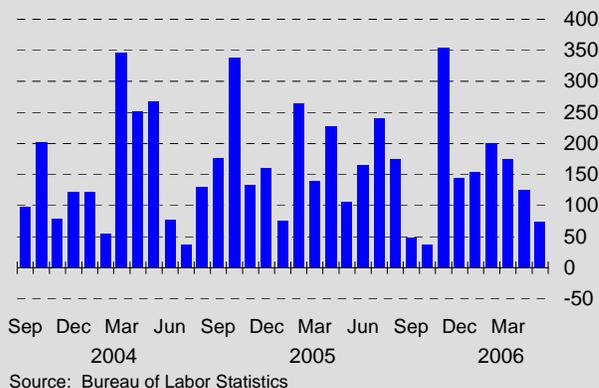
Highlights

- Gross domestic product [GDP] – a broad measure of the Nation's output of goods and services – grew by 5.3 percent in the first quarter of 2006. This was an upward revision from the 4.8-percent figure reported at the end of April.
- A total of 75,000 new jobs were created by business establishments in May, the 33rd consecutive month of job gains. Nevertheless, it was the third consecutive monthly decline in jobs created, and the rate of job creation in May was about half that of the previous year (see Figure 1.) Other data showed that the unemployment rate declined to 4.6 percent, the lowest in more than 5 years.

- The Consumer Price Index [CPI], the most common measure of inflation, was up by 0.4 percent in April compared to March, to an annual rate of 4.2 percent. Core prices (excluding food and energy) were up 0.3 percent, to 2.4 percent over the year.
- Comments by the Federal Reserve revealed that officials were much less troubled by evidence of a gradually slowing economy than they were by unwelcome signs of inflation. With core inflation running at or above their "comfort level" of 1 percent to 2 percent, various comments by Fed officials seemed to signal of another forthcoming rate hike, which would be the 17th over a 2-year period.

5.3 Million Jobs in Past 33 Months
(Change in employment, in thousands)

Fig. 1



Moderation Expected in Second Quarter

The 5.3-percent (revised) first-quarter growth in GDP was driven by strong contributions from consumption expenditures, equipment and software, exports, and Federal Government spending. GDP has grown above the 3-percent historical average for 18 consecutive quarters. The *Blue Chip* forecast – a monthly consensus of private forecasters –

(continued on reverse side)

is for real GDP to grow at 3.4 percent for the year overall, but to slow this quarter to 2.9 percent, and to remain at 2.8 percent for the last two quarters of this year (see Table below).

Blue Chip Economic Outlook, June 2006								
	2005				2006			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
	<i>Actual</i>				<i>Projected</i>			
Real GDP Growth	3.8	3.3	4.1	1.7	5.3	2.9	2.8	2.8
Unemployment Rate	5.3	5.1	5.0	4.9	4.7	4.7	4.7	4.8
CPI Inflation	2.3	3.8	5.5	3.3	2.2	4.2	2.6	2.3
3-month Treas. Bill	2.5	2.9	3.4	3.8	4.4	4.8	5.0	5.1
10-year Treas. Note	4.3	4.2	4.2	4.5	4.6	5.1	5.2	5.3

Job Creation Moderates

As noted, the 75,000 new jobs created in May represents the 33rd consecutive monthly increase in nonfarm payroll employment. More than 5.2 million new jobs have been added to payrolls in that period, and around 2.0 million new jobs have been created in the past year alone.

Although monthly job growth data are notoriously volatile, the trend of recent figures does suggest some softening in the labor markets, especially in the construction, retail, and manufacturing sectors. The view is reinforced by data indicating a decline in hours worked and a 0.1 percent drop in average hourly earnings. Job gains were less than half the rate of monthly job increases over the previous year.

In contrast, the unemployment rate, based on a survey of households, declined to 4.6 percent, the lowest rate since July 2001 and below the averages of the 1960s, 1970s, 1980s, and 1990s. The unemployment rate has fallen by 1.7 percentage points since its recent peak of 6.3 percent in June 2003.

Price Inflation

Driven by a 2.3-percent May increase in energy prices (up 3.6 percent over the year), the overall Consumer Price Index [CPI] increased by 4.2 percent compared to May of last

year. Core CPI inflation (which excludes inflation in energy and food prices) was up 2.4 percent compared to a year ago. One factor currently affecting growth in core inflation is “owner’s equivalent rent,” a proxy measure for the price of rental housing: it grew by 0.6 percent over April, and is up 3.3 percent for the year.

Federal Reserve Policy

The Fed is currently engaged in a struggle to keep energy and commodity price inflation out of the general price level, and thereby continue to foster sustainable growth and investment. Reducing expectations of future inflation is seen as crucial; and the Fed could achieve it by raising the overnight interest rate for Federal funds to 5.25 percent at the next FOMC meeting on 29 June. The Fed has raised overnight rates in a sequence of 16 quarter-point hikes that began in June 2004, bringing the overnight rate from 1.00 percent to the current 5.00 percent.

Fed officials have expressed their inflation concerns – and their willingness to continue raising rates – in both FOMC minutes and in other public forums. Financial markets are currently assigning a close to 100 percent probability of a quarter-point rate hike in June.

Housing Growth Slows Moderately

Along with increases in energy prices, further evidence of weakening in the housing markets goes far in explaining expectations of moderating economic growth. Total housing starts fell for the third consecutive month in April. Both new home and existing home sales are running 4.7 percent below a year ago. Price growth has also moderated, as the median sales price of new homes is up 0.9 percent compared to a year ago, while existing homes were up 4.2 percent.

Upcoming Indicators

GDP - A final estimate of GDP growth for the 1st quarter of 2006 is scheduled for release on *June 29*.

Federal Reserve - The Fed’s next monetary policy meeting is scheduled for *June 28 and 29*.

Employment - June employment and unemployment data are scheduled for release on *July 7*.

Prepared by Jeffrey W. Hopkins
 Chief Economist